



IN THE

Supreme Court of the United States

October Term, 1942

No.

THE FRANCE STONE COMPANY,

*Petitioner,**vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.***BRIEF IN SUPPORT OF PETITION FOR WRIT OF
CERTIORARI****I.****STATEMENT OF THE CASE**

Reference is made to the foregoing petition for Summary Statement of the Case, Citation of Opinions Below and Statement as to Jurisdiction.

II.**SPECIFICATIONS AND ASSIGNMENTS OF ERROR**

1. The court below erred in affirming and not reversing the judgment of the United States Tax Court for respondent.
2. The court below erred in holding that the contract between petitioner and its preferred shareholders was not such a contract as is contemplated by the provisions of Section 26(c) (1) of the Revenue Act of 1936 as amended by Section 501 of the Revenue Act of 1942.

3. The court below erred in holding that the issue before it was controlled by the rule laid down by this court in the case of *Helvering vs. Northwest Steel Rolling Mills, Inc.*, (1940), 311 U. S. 46.

4. The court below erred in refusing to hold that the retroactive amendment to Section 26(c) (1) of the Revenue Act of 1936 enacted by the Congress in Section 501 of the Revenue Act of 1942 enlarged the scope, meaning and application of the provisions of Section 26(c) (1) of the Revenue Act of 1936.

5. The court below erred in not allowing to petitioner the credit amounting to \$66,572.31 claimed by it as a reduction of its undistributed net income for the year 1937 and in refusing to hold that there was no undistributed net income of petitioner subject to surtax under Sections 14(a) (1) and 26(c) (1) of the Revenue Act of 1936 as amended by Section 501 of the Revenue Act of 1942.

III.

SUMMARY OF ARGUMENT

1. The decision of the court below is in direct conflict with the decision of the United States Circuit Court of Appeals for the Third Circuit in the case of *Lehigh Structural Steel Company vs. Commissioner* (1942), 127 F. 2d 67.
2. The decision of the court below is probably based upon an erroneous interpretation of and is probably in conflict with the rule of law announced by this court in the case of *Helvering vs. Northwest Steel Rolling Mills, Inc.*, (1940), 311 U. S. 46.
3. The decision of the court below fails to recognize that the retroactive amendments to Section 26 of the Revenue Act of 1936 enacted by the Congress at Section 501 of the Revenue Act of 1942 enlarged the scope, meaning and application of the provisions of Section 26(c) (1) of the Revenue Act of 1936.

IV.

ARGUMENT

1. The Decision of the Court Below Is in Direct Conflict With the Decision of the United States Circuit Court of Appeals for the Third Circuit in the Case of *Lehigh Structural Steel Company vs. Commissioner* (1942), 127 F. 2d 67.

The contract in question between petitioner and its preferred shareholders which was entered into by the parties early in 1933 (R. 27) contained the following provision (R. 43):

“After providing for the payment of the cumulative dividend then due on the preferred shares and before any dividends are declared, paid or set aside to or for other shareholders, the Directors shall set aside from the remaining surplus earnings for each year, a sum equal to five per cent (5%) of the par value of all of the preferred shares then outstanding as a Sinking Fund to be held and used for the redemption of the preferred shares as hereinafter provided, and for no other purpose. This Sinking Fund provision shall be cumulative so that if in any year, the surplus earnings of the corporation shall be insufficient for the purpose of setting aside the aforesaid amount so provided for Sinking Fund, then no dividend shall be paid to, or declared or set aside for any shareholders other than the preferred shareholders.”

To January 1, 1937, the amounts required to be set aside as a Sinking Fund to be held and used for the redemption of preferred stock under the terms and provisions of the preferred stock issue aggregated \$385,000 (R. 28). Owing to net losses in its operations for years prior to 1936 the total amount actually set aside for the sinking fund under petitioner’s preferred stock issue up to December 31, 1937, was only \$300,000 which included contributions of \$63,000 during the year 1936 and \$37,000 during

the year 1937 (R. 27 and R. 28). At the end of 1937 petitioner had outstanding \$700,000 par value of its 6% cumulative preferred stock (R. 28). Up to December 31, 1937, dividends were paid annually upon the preferred shares (R. 28). From 1931 through 1937, inclusive, dividends were paid upon the Class A common stock at the rate of ten cents per share, or a total annual payment of \$1,000 (R. 29). This payment was made since the corporation desired to continue the dividend record of the company which had paid a dividend upon its common stock since its beginning (R. 16 and R. 17). No dividends were paid upon the Class B common stock during the year 1937.

On account of its lack of profits out of which such sinking fund provisions might have been made in prior years and on account of the consequent deficiency in the Preferred Stock Sinking Fund petitioner was restricted from paying dividends upon its common stock by the terms and provisions of its contract with its preferred shareholders above referred to. Consequently the petitioner contends that it was entitled to a credit of \$66,572.31 under the provisions of Section 26(c) (1) of the Revenue Act of 1936, *supra*, which would have had the result of eliminating its undistributed profits for the year 1937, thus resulting in no surtax liability for said year. Respondent, the United States Tax Court, and the court below, however, concluded that the contract between petitioner and its preferred shareholders was not such a contract as was contemplated by Section 26(c) (1) of the Revenue Act of 1936. The court below based its conclusion upon the decisions rendered by it in the cases of *Warren Telephone Company vs. Commissioner*, 128 F. 2d 503 (certiorari denied Jan. 11, 1943), and *Metal Specialty Company vs. Commissioner*, 128 F. 2d 259.

The *Metal Specialty Company* case and the *Warren Telephone Company* case were decided in the court below

on the same day (June 2, 1942). On March 27, 1942, the United States Circuit Court of Appeals for the Third Circuit decided the case of *Lehigh Structural Steel Company vs. Commissioner*, 127 F. 2d 67. There the taxpayer was contending that it was entitled to the credit afforded by Section 26(c) (1) of the Revenue Act of 1936 by reason of a provision in its agreement with its preferred shareholders almost identical with the provision in the contract between petitioner and its preferred shareholders which has been hereinbefore quoted. In the *Lehigh Structural Steel Company* case the court decided that the contract between the taxpayer corporation and its preferred shareholders met the statutory test and that therefore the taxpayer was entitled to the credit as claimed under Section 26(c) (1) of the Revenue Act of 1936.

The United States Circuit Court of Appeals for the Sixth Circuit in the *Warren Telephone Company* case recognized that its decision was in conflict with the rationale of the opinion by the Third Circuit Court of Appeals in the *Lehigh Structural Steel Company* case and in that connection made the following statement in its opinion (page 506):

"This view is not in accord with that of the Third Circuit Court of Appeals in *Lehigh Structural Steel Company vs. Commissioner*, 127 F. 2d 67."

Thus the United States Circuit Court of Appeals for the Sixth Circuit in deciding this case upon the authority of its decision in the *Warren Telephone Company* case, specifically recognizes that its decision in this case is in direct conflict with the decision by the United States Court of Appeals for the Third Circuit in the *Lehigh Structural Steel Company* case.

While *certiorari* was denied in the *Warren Telephone Company* case, it is entirely possible that the denial was due to the fact that the Solicitor General in his memoran-

dum in opposition to the granting of the writ admitted in the footnote at page 9 of his memorandum that the taxpayer, a deficit corporation, was entitled to the benefits afforded by Section 501 of the Revenue Act of 1942, and that a tentative computation resulted in the elimination of the greater portion of the deficiency there involved. Since petitioner here is not a deficit corporation no such relief can be conceded in the instant case.

It might also be well to mention that the Third Circuit Court of Appeals indicated in the case of *Eljer Company vs. Commissioner*, decided on February 24, 1943, and as yet unreported, that its views as announced in the case of *Lehigh Structural Steel Company vs. Commissioner, supra*, have not in any way been modified by the conflicting opinion of the Sixth Circuit in the *Warren Telephone Company* case.

2. The Decision of the Court Below Is Probably Based Upon an Erroneous Interpretation of and Is Probably in Conflict With the Rule of Law Announced by this Court in the Case of *Helvering vs. Northwest Steel Rolling Mills, Inc.*, (1940), 311 U. S. 46.

The court below decided the instant case as well as the *Warren Telephone Company* and *Metal Specialty Company* cases upon what it conceived to be the rule laid down by this court in the case of *Helvering vs. Northwest Steel Rolling Mills, Inc.*, 311 U. S. 46, whereas the United States Circuit Court of Appeals for the Third Circuit reached an exactly opposite conclusion in the *Lehigh Structural Steel Company* case upon almost identical facts.

In the case of *Helvering vs. Northwest Steel Rolling Mills, Inc., supra*, it appeared that credit was there claimed under Section 26(c) (1) because (1) of an oral agreement with a bank that all surplus money over and above that

needed for current operating expenses would be applied by the company on its indebtedness to the bank; and (2) because the company had a deficit in capital account and could not therefore declare or pay any dividends under the laws of the State of Washington, the state of its incorporation. This court in interpreting the provisions of Section 26(e) (1) held that Northwest Steel Rolling Mills, Inc., was not entitled to the credit as claimed because the contract was not a written contract executed by the corporation which "expressly deals with the payment of dividends" and refused to approve the taxpayer's attempt to characterize its corporate charter as a contract within the meaning of Section 26(e) (1). In order to emphasize its decision with respect to the taxpayer's contention in the *Northwest Steel Rolling Mills* case, this court proceeded to analyze Section 26(e) (2) of the Revenue Act of 1936. That section (Section 26(e) (2)) gave a similar credit to a corporation which was prevented from paying out its earnings and profits for the taxable year in dividends by the terms and provisions of a written contract entered into by the corporation prior to May 1, 1936, with a creditor of the corporation. This court reached the conclusion that Section 26(e) (1) of the Revenue Act of 1936 should be as strictly construed as Section 26(e) (2) of that Act, since the claimed credit involved a specially permitted deduction.

However, this court did not read into Section 26(e) (1) the provision that a contract in order to come within the provisions of Section 26(e) (1) must be a routine contract with a creditor of the corporation, but the Sixth Circuit Court of Appeals in the *Warren Telephone Company* case, *supra*, thus fell into error. In that case the court wrote into Section 26(e) (1) the additional limitations not contained in the Act, that contracts in order to come within the provisions of Section 26(e) (1) must be "routine contracts dealing with ordinary debts and not to statutory

obligations." Thus the Circuit Court of Appeals for the Sixth Circuit wrote into Section 26(c) (1) two limitations not contained in the Act, namely, (1) that the contract must be a routine contract dealing with ordinary debts and not to statutory obligations; and (2) that the contract must be entered into by the corporation with its creditor, but this court in the *Northwest Steel Rolling Mills* case, *supra*, when it was discussing "debts" and "creditors" in its opinion, was discussing Section 26(c) (2) and not Section 26(c) (1).

The United States Board of Tax Appeals in the case of *Reclaimed Island Lands Company*, 46 B. T. A. 1048-1057, concluded that what this court was pointing out in the *Northwest Steel Rolling Mills* case, *supra*, by use of the expression "routine contracts" was a distinction between contractual obligations and statutory obligations. In that case the Commissioner was attempting to disqualify a contract between a corporation and one of its stockholders who had guaranteed certain of the company's obligations.

The Third Circuit Court of Appeals in the *Lehigh Structural Steel Company* case, *supra*, was not at all disturbed by the expression "routine contracts" as used by this court in the *Northwest Steel Rolling Mills* case. That court reached the unqualified conclusion that a contract between a corporation and its preferred shareholders such as is here involved, is within the application of Section 26(c) (1) of the Revenue Act of 1936. That court concluded that the decision of this court in the *Northwest Steel Rolling Mills* case, *supra*, had reference only to so-called "deficit corporations" or to statutory obligations of a corporation as distinguished from its contractual obligations. Thus the direct conflict arose between the Third Circuit Court of Appeals and the Sixth Circuit Court of Appeals which was expressly recognized by the Sixth Circuit Court of Appeals in its opinion in the *Warren Telephone Company* case.

It is deemed advisable to bring before this court three very significant facts arising out of or related to this conflict of opinion between the Circuit Courts of Appeal with respect to the meaning and significance of the decision of this court in the *Northwest Steel Rolling Mills* case, *supra*, namely:

1. The Commissioner of Internal Revenue sought no writ of *certiorari* to review the decision of the Third Circuit Court of Appeals in the case of *Lehigh Structural Steel Company vs. Commissioner*;

2. The Solicitor General of the United States in his brief on behalf of the Commissioner of Internal Revenue in the case of *Crane-Johnson Company vs. Helvering*, 311 U. S. 54, which was a case exactly like that of *Helvering vs. Northwest Steel Rolling Mills, Inc.*, said on pages 7 and 8:

“Petitioner’s alternative argument, not raised before the Board or properly presented to the court below, that its stock certificates were written contracts executed by it and that the North Dakota statute was a part of such contracts, was untenable. Although stock certificates containing express restrictions against dividend payments would come under Section 26(c) (1), a state law restricting dividend payments, which is at best an implied provision of the stock certificates, does not satisfy the requirements of the section.” (Emphasis ours.)

3. When Warren Telephone Company petitioned this court for a writ of *certiorari* to the United States Circuit Court of Appeals for the Sixth Circuit the Solicitor General of the United States pointed out to this court on page 9 of his memorandum in opposition to the petition that the taxpayer in that case was entitled to certain relief in view of “the relief provisions (retroactive to 1936) with respect to deficit corporations in the Revenue Act of 1942” and conceded that “the question presented by the conflict may become moot in a number of the pending cases.” However, the Solicitor General in his memorandum at page 8 in commenting upon the conflict between the decisions of the Sixth Circuit Court of Appeals in the *Warren Telephone Company*

case and the Third Circuit Court of Appeals in the *Lehigh Structural Steel Company* case conceded that "it would be appropriate for the court to grant *certiorari* in view of the conflict."

Thus it would appear that the only solution to the confusion now existing would be to grant *certiorari* in the instant case so that all doubts with respect to the meaning and significance of this court's opinion in the *Northwest Steel Rolling Mills* case may be forever resolved.

3. The Decision of the Court Below Fails to Recognize That the Retroactive Amendments to Section 26 of the Revenue Act of 1936 Enacted by the Congress at Section 501 of the Revenue Act of 1942 Enlarged the Scope, Meaning and Application of the Provisions of Section 26(c) (1) of the Revenue Act of 1936.

When the Tax Bill of the Revenue Act of 1936 originated in the House of Representatives it was clearly apparent that the House intended that the undistributed profits tax which was new in that Act should be imposed upon those corporations which could but would not pay dividends to their shareholders.¹ The House Bill granted exemptions from the tax to those corporations which could not pay dividends for various reasons. Those exempt corporations might be classified as follows:²

1. Those corporations which were obligated under written contracts entered into prior to May 1, 1936, to refrain from paying dividends during the taxable year.
2. Those corporations which were obligated under written contracts entered into prior to May 1, 1936, to apply

¹See the Report of Hearings before the Committee on Ways and Means of the House of Representatives re Revenue Act of 1936, 74th Congress, Second Session, pages 14 to 26.

²See H. R. 12395, 74th Congress, Second Session, Sections 14, 15 and 16; H. Rep. No. 2475, 74th Congress, Second Session, pp. 8-9.

their earnings for the taxable year in the reduction of indebtedness due and owing to a creditor.

3. So-called deficit corporations which were prevented from paying dividends during the taxable year by some statutory requirement of the state of their incorporation.

That the House of Representatives intended to include as a contract within the application of the first exemption a contract between a corporation and its preferred shareholders, as is here involved, is unrefutably demonstrated by the colloquy reported at pages 61 and 62 of the Hearings before the Committee on Ways and Means of the House of Representatives, 74th Congress, Second Session, where such contracts as here involved were expressly designated as being within the exemption.

When the Bill reached the Senate, the Senate Finance Committee deleted the third exemption hereinabove referred to and thus the Bill was finally passed by the Congress. It was to some extent on account of this deletion of the third exemption enumerated above that this court in the case of *Helvering vs. Northwest Steel Rolling Mills*, *supra*, reached the conclusion that the taxpayer there involved, a so-called deficit corporation, was not entitled to the credit claimed against undistributed income subject to the levy of the undistributed profits tax. After the decision by this court in the *Northwest Steel Rolling Mills* case, *supra*, Congress in enacting the Revenue Act of 1942, at Section 501 thereof, retroactively restored the exemption to deficit corporations which were prevented from paying dividends during the taxable year by some statutory requirement of the state of their incorporation.

While petitioner contends that the deletion by the Senate of the exemption for deficit corporations in the course of the enactment of the Revenue Act of 1936 in no wise affected the exemption afforded by Section 26(e) (1) of the Act, namely, to corporations which were contrac-

tually obligated prior to May 1, 1936, to refrain from paying dividends during the taxable year, yet if it can be said that the deletion by the Senate of the third exemption in any way narrowed the application of the first exemption, petitioner now contends that the retroactive restoration of the third exemption by Section 501 of the Revenue Act of 1942 completely restores the aim and purpose of the undistributed profits tax of the Revenue Act of 1936 as it originated in the House of Representatives. That aim and purpose, as has been hereinbefore stated, was to impose the surtax upon those corporations which could but would not pay dividends to their shareholders during the taxable year. Petitioner submits that it was contractually obligated under the terms and provisions of its contract with its preferred shareholders to refrain from paying dividends to its common stockholders in the year 1937 and that therefore it could not pay any dividends in addition to those which it paid to its preferred shareholders. Thus petitioner claims it is entitled to the credit afforded by Section 26(c) (1) of the Revenue Act of 1936 as amended by Section 501 of the Revenue Act of 1942.

It is therefore submitted that the writ of *certiorari* should be allowed as prayed for and that the judgment of the court below should be reversed.

Respectfully submitted,

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